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**SHAREHOLDER HETEROGENEITY AND CONFLICTING GOALS:
STRATEGIC INVESTMENTS IN THE JAPANESE ELECTRONICS INDUSTRY**

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SHAREHOLDER HETEROGENEITY AND CONFLICTING GOALS: STRATEGIC INVESTMENTS IN THE JAPANESE ELECTRONICS INDUSTRY

ABSTRACT

This article investigates the effects of the changing institutional environment on strategic orientations of Japanese electronics firms during the 1990s. We examine the effects of three different types of shareholders on strategic directions of their invested firms. The first one, foreign portfolio investors, characterizes the emerging influence that pressed for change in corporate strategies. The two domestic shareholders, corporate investors and financial institutions, represent the conventional forces for continuity. Between the two domestic forces, though, while corporate investors attempted to maintain status quo, financial institutions have shifted toward market-oriented behavior of investment. Specifically, we explore (1) the influence of each type of shareholders on a firm's diversification strategy and capital commitment; and (2) the moderating effects of firm performance on the relationships between ownership structure and strategic choices. The results suggest that foreign investors prefer the focused product portfolio and conservative capital commitment. They also prefer the reduction of capital investment when the financial performance of their invested firms is poor. Domestic financial institutions are now similarly sensitive to the performance of their invested firms when those firms make strategic investments. By contrast, domestic corporate shareholders remain indifferent to performance, while they aim to maintain relational business ties with invested firms.

Key Words: capital investment, corporate governance, diversification strategy, institutional change, Japan, shareholder heterogeneity

INTRODUCTION

Corporate governance is an institutional element of a nation's business system and hence reflects economic and social structures and norms of key stakeholders in society (Fiss and Zajac, 2005; Guillen, 1999; Whitley, 1992). This implies that corporate governance practices are usually hard to change. Despite their emphasis on stability and continuity, however, institutions and their elements do change from time to time (Fiss and Zajac, 2005; Yoshikawa, Tsui-Auch, and McGuire, 2007). Because of the globalization of capital markets and, to a lesser extent, product markets, the corporate governance system in many nations is facing increasing pressures to change (Khanna and Palepu, 2004; Useem, 1998). Since capital market pressures are largely imposed by institutional investors from the U.S. and the U.K., there is a view that corporate governance of non-Anglo-American countries is moving toward more shareholder-oriented corporate governance models (Bebchuck and Roe, 1999; Hansmann and Kraakman, 2001). While organization theorists generally do not support the argument that strong convergence of corporate governance models is taking place (Gilson, 2004; Guillen, 1999, 2000), local firms still need to decide how to respond to these mounting pressures caused by the rise of global institutional ownership.

In the Japanese context, for example, this changing institutional environment is reflected in the conflicting demands between foreign portfolio investors and domestic relational shareholders, each of which represents different institutional norms (Ahmadjian and Robbins, 2005; David *et al.*, 2010). The Japanese system has long been characterized by large shareholdings by domestic affiliated interests including corporate owners and financial institutions that hold various stakes in on-going business relationships with the firms in which they invest (Clark, 1979; Gerlach, 1992). Yet, there is a growing presence of more market-oriented shareholders, especially foreign portfolio investors, who seek financial returns. Hence, there is a rising pressure on managers of Japanese firms to mediate the different forces and even shift their priorities amid the rising institutional pressures for change (Yoshikawa and McGuire, 2008).

Previous studies that examined the ownership structure of Japanese firms found that foreign investors and their domestic counterparts have different investment objectives, which influence the

strategic behavior of their invested firms: foreign owners foster downsizing through decreasing the number of permanent employees and asset divestiture (Ahmadjian and Robinson, 2001; Ahmadjian and Robbins, 2005), pressuring to reduce employee wages under performance declines (Yoshikawa *et al.*, 2005), promoting appropriate R&D and capital investment (David *et al.*, 2006), and are associated with improved corporate performance (Miyajima, 2007; Miyajima and Kuroki, 2007; Yoshikawa and Rasheed, 2010). Domestic owners, by contrast, inhibit corporate restructuring (Ahmadjian and Robinson, 2001; Ahmadjian and Robbins, 2005), protect employee welfare even under poor performance (Yoshikawa *et al.*, 2005) and tend to be linked to depressed financial outcomes (Miyajima, 2007; Miyajima and Kuroki, 2007). A more recent study by David and colleagues (2010) examines the performance implications of diversification strategy under different ownership composition and illustrates that the relationships between diversification measures and profit outcomes are more positive with higher ownership by foreign investors relative to domestic ones. The relationships between diversification strategy and firm growth are more clearly detected for the firms with higher domestic ownership than foreign ownership. These results clearly show that foreign and domestic owners have different investment objectives and strategic preferences.

Building on and extending these prior studies, our present research examines the effects of the changing institutional environment on strategic choices adopted by Japanese electronics firms during the 1990s, the period characterized by nagging economic recession, poor corporate performance and rising investor pressures. The main contribution of this study is that it synthesizes the findings of previous studies on the effects of ownership heterogeneity on corporate restructuring and strategic reorientations by investigating the contingent effects of financial performance on the characteristic preferences of foreign and domestic shareholders over product diversification and capital investment. Specifically, we investigate the strategic implications of those owners' sensitivity to firm performance by examining how the preferences of different types of shareholders in terms of corporate investment shift when the levels of profitability of their invested firms differ.

The present study further makes an important extension to previous works by systematically

examining the behavioral differences that heterogeneous domestic investors in Japan exhibit. Previous studies (including the most recent study by David *et al.*, 2010) customarily treat Japanese domestic owners as one coherent group with similar investment priorities.¹ We argue however that the objectives of domestic financial owners started diverging from those of domestic corporate owners during the recession period. Hence, combining them into the same category glosses over the emerging differences among domestic owners in the Japanese context. Our analyses indeed suggest that financial institutions demonstrate characteristic behavior that is different from what past research has theorized. The three types of owners, foreign, domestic corporate and domestic financial, actually exhibit different strategic preferences of their invested firms.

We investigate the period of economic downturn in Japan because strategic resource allocation is especially critical in an environment when external market opportunities are limited, and available firm resources are also in decline. In other words, performance implications of a firm's strategic choices can be amplified during a recessionary period (Colpan, 2008). In addition, the way Japanese firms mediated the interests of different investors that represent dissimilar goals provides an insight on how institutional change may take place. We chose the electronics industry, because it has been recognized internationally as one of the most dynamic, global, and competitive industries in Japan (Chandler, 2001). This industry also represents an important case in which foreign institutional investors had been making extensive financial commitments since the early 1980s and is hence more exposed to global capital market pressure than other Japanese industries.

THEORY AND HYPOTHESES

Institutional Continuity and Change

Institutions can be defined as both formal and informal rules that constrain human interaction in a society (North, 1991) or shared rules including laws and collective understanding (Fligstein, 1996). These definitions share the notion that institutions provide a framework for social interaction and thereby make social order possible by reducing uncertainty. Since institutions are social structures that are

composed of cognitive, normative, and regulative elements that are embedded in a local context, they are usually highly resistant to change (Scott, 2001). Hence, institutions tend to reinforce the continuity of established systems, behavior, and practices.

However, institutions can change due to both external and internal pressures (Oliver, 1992; Scott, 2001). Oliver (1992) distinguishes the functional, political, and social sources of institutional change. While functional pressures may arise when firm performance raises a question on the appropriateness of existing practices or policies, political pressures arise through shifts in interests and balance of power among key actors that can lead to legal and regulatory changes (Fligstein, 1996). Social pressures stem from changing social expectations within a society or institutional field. For example, the rising awareness of corporate governance, especially in the Anglo-American models, led to the formalization of corporate governance codes in many countries (Aguilera and Cuervo-Cazurra, 2004).

Prior research tends to treat the globalization of market forces, especially capital markets, as the dominant force that pushes corporate governance practices and firm behavior of non-Anglo-American countries toward the U.S. models of corporate governance and more market-oriented practices (e.g., Ahmadjian and Robbins, 2005; Useem, 1998). Despite the rise of global institutional ownership, however, each institutional context has different types of shareholders with varying investment objectives (Tan, 2002; Johnson *et al.*, 2010). For example, many emerging economies and some developed economies are dominated by family-owned firms (Carney and Gedajlovic, 2002; Peng *et al.*, 2008; Thomsen and Pedersen, 2000). Since such domestic investors are often embedded in the local institutional context and have strategic as well as long-term interests in their shareholdings, they are the actors who maintain the local institutional rules. In short, they play the role of the agent to protect or maintain continuity.

Not all domestic relational shareholders prioritize strategic goals all the time, however. Some of them may be pushed to change their preferences when they are under internal and external pressures. As long as their financial standing is sound enough to please their own shareholders, those investors remain silent and cooperative partners. When the macroeconomic environment is recessionary and firms thus face financial difficulties, however, they may start to actively demand their invested firms to enhance

financial performance to maintain share prices at reasonable levels and to secure adequate dividends. Within the recessionary economic environment, even certain domestic investors that had remained relational to their invested firms may face the acute pressure to adjust their preferences.

Global institutional investors, on the other hand, act according to the rules of global capital markets that are based on the premise that management chooses strategies that maximize investors' financial returns. Hence, the norms of global capital markets are sometimes in conflict with the local institutional norms. As foreign ownership increases, firms in non-Anglo-American countries including Japan will be under increasing pressures to respond to global institutional investors. Nevertheless, they can also rely on their domestic relational investors to shield them from external market forces, at least to some extent, because such investors often prefer the existing practices. Hence, during institutional transitions, both continuity and change often co-exist.

Research Context

Researchers often categorize the corporate governance system broadly into two types: the shareholder- or market-oriented system of Anglo-American countries and the stakeholder-oriented system found in economies such as Japan and continental European countries (Albert, 1993; Dore, 2000). Along with Germany, Japan is usually categorized as a country where firms have maintained strong stakeholder orientations. The Japanese system is characterized by tight keiretsu networks of vertical and horizontal groupings that are known for their cross-shareholdings and financial, human and transactional ties (Gerlach, 1992; Lincoln and Gerlach, 2004; Sheard, 1994). Instead of owning stocks primarily as portfolio investments or for financial purposes, such domestic investors are often business partners or commercial banks, both of which hold shares for the implicit purpose of business goodwill, information exchange, and mutual monitoring (Clark, 1979; Kester, 1991). A recent study by David and colleagues (2010) thus argue that relational domestic owners in Japan appropriate rents “through higher growth that yields both enhanced business prospects and stronger mutual safeguards”. It also suggests that domestic owners' embedded relationships foster their positive attitudes towards important stakeholders including

employees and management. Prior research also proposes that these domestic shareholders often own shares in other firms to ensure stability in earnings and sales so that they can protect the benefits of their business partners that are often members of the same corporate group (Caves and Uekusa, 1976; Gedajlovic and Shapiro, 2002; Nakatani, 1984). They are thus similar to what Aguilera and Jackson (2003) categorize as investors that have strategic interests as opposed to financial interests and are concerned with multiple goals such as “regulating competition between firms, underwriting relational contracts, securing markets, managing technological dependence, and protecting managerial autonomy from outside shareholders” (451). Consequently, managers of large Japanese firms have traditionally paid less attention to the interests of non-affiliated or more market-oriented investors that seek financial gains.

In addition, in the Japanese system, employees have been identified as one of the key stakeholders of a firm. In the post-war period, the Japanese system placed greater emphasis on lifetime or long-term employment relationships, which was often cited as a critical factor for the growth of the Japanese economy (Aoki, 1990; Cole, 1979). Comparing employee tenure in the U.S. and Japanese firms, the ratio of employees who spent over 10 years with the same employer was only 25.8% in the U.S., whereas it was 43.2% in Japan in 2000 (Auer and Cazes, 2003: 25). As there are social norms against employee layoffs (Usui and Colgnon, 1996), Japanese firms are slow to reduce the number of employees even during performance downturns (Ahmadjian and Robinson, 2001; Kang and Shivdasani, 1997).

However, the market environment that started to deteriorate in the early 1990s began to impose some strains on the Japanese institutional system (Jackson, 2003; Yoshikawa *et al.*, 2007). The globalization of stock ownership by international investors and relatively depressed Japanese equity prices following the burst of the bubble economy in the early 1990s led to a significant increase in foreign portfolio investment in Japan. Their holdings of Japanese stocks by market value sharply increased from about 4.7% in 1990 to 27.6% in 2007 (Tokyo Stock Exchange, 2008). Foreign portfolio investors are predominantly institutional ones from the U.S. and the U.K. that on average constituted 38.4% and 31.5%, respectively, of all foreign equity investments in Japan between 1996 and 2008 (Bank of Japan, 2000-10). Those investors pursue strictly financial objectives from their investments, as they are usually arms-length

investors and therefore do not benefit from any commercial transactions with invested firms (Ahmadjian and Robbins, 2005; Okabe, 2002). As David and colleagues (2010) argue, they are transactional investors that appropriate rents solely through higher financial returns. Foreign portfolio investors hold shares in Japanese firms as a part of their global portfolio in order to earn profits and also diversify investment risk. Hence, their invested firms will be pressured to pursue higher returns on their capital and adopt more shareholder-oriented corporate governance models (Jackson and Moerke, 2005).

As foreign portfolio investors tend to trade shares more frequently than domestic investors, their holdings disproportionately affect the share price of Japanese firms. In terms of trading volume, foreign shareholders accounted for more than 50% in 2007 (Tokyo Stock Exchange, 2008). Therefore, even when those investors own a relatively small block of shares, they can affect the strategic decisions of their invested firms (David *et al.*, 2006; David *et al.*, 2010; Nitta, 2000). In addition to this *exit* option, they can also use *voice* to influence Japanese managers through direct meetings with the management of the Japanese firms (Ahmadjian and Robbins, 2005). Hence, Japanese managers are now keenly aware of the interests of foreign investors. Commenting on their influence, a senior manager of a major electronics firm with large foreign ownership noted:

“As we have many foreign investors, it is not sufficient if we only stick to the Japanese model. Therefore.....we would like to move toward a model that is valued highly by foreign investors” (author’s interview²).

Besides this critical rise in foreign portfolio investors, another significant change in investor profiles in the 1990s came from the composition and behavior of domestic investors themselves. Financial institutions, especially banks, were saddled with huge bad loans with the burst of the bubble economy in the early 1990s. In order to maintain their financial health, even sizable commercial banks started cutting back their conventional ties to their *keiretsu* firms (Inoue 1999; Yasui 1999; Gedajlovic *et al.*, 2005). Another significant category of domestic financial institutions, insurance companies, also reduced their proportion of corporate shareholdings from around 13% in 1990 to about 5% in 2007 (Tokyo Stock Exchange, 2008). The insurance companies had been a relational investor in that they often

handled various insurance-related businesses. However, the insurance companies also started experiencing financial difficulties in the 1990s as their revenues from insurance businesses of their invested firms stagnated, and dividend and interest income from various forms of investments substantially fell. Hence, they were under strong pressure to improve their financial performance to increase the insurance sales volume and improve financial return from investments. Recent accounts often suggest that insurance companies as well as commercial banks have slowly started incorporating market-oriented elements of investment principles, although they still follow the basic rule of stable relational shareholders (Kikuchi 1999; Yasui 1999).

Amid these shifts, the only major category of shareholders that did not fundamentally alter its investment principle was the corporate firms that had long-term transactional ties with their invested companies. Those firms continued to keep their stockholdings in other corporations for relational goals, as that equity relationship remained a symbolic tie between the two firms (Arikawa and Miyajima, 2007). For those firms, thus, immediate financial returns from investments still remained secondary, relative to revenues resulting from continuing business transactions with invested firms. As such, the shareholdings by business corporations remained relatively high at around 20% in 2008, even though the proportion had certainly declined from about 30% in 1990 (Tokyo Stock Exchange, 2008).

Following the arguments above, we theorize that global institutional investors function as a prime agent of change, and poor firm performance due to economic downturn inflates their pressure and influence. Specifically, during the recessionary period, it is hypothesized that foreign portfolio investors promote restructuring of diversified product portfolios, because they assume that a greater focus on profit-generating businesses alone enhances profitability. They also demand to reduce capital investment committed by their invested firms, as those firms had often already been saddled with idle capacities resulted from expansive investments in production facilities that they committed to in the booming 1980s. Rather than making additional capital investments, foreign institutional investors preferred that their invested firms curtail idle facilities to lower production costs in order to be more competitive. That way, international portfolio investors attempt to achieve the ultimate goal of maximizing immediate financial

return on their investments.

Domestic financial institutions on the other hand, faced a dilemma in that they aimed to maintain the conventional transactional ties with the invested corporations, while also being portfolio investors by nature. This dual character is hidden in the booming macroeconomic settings, as maintaining and enhancing relational business ties should result in the performance gains of financial institutions as well as invested corporations. When business environments sour, however, the financial institutions may often encounter a difficult circumstance in that they may still aim to keep the conventional ties, but that relational behavior would harm their own financial standing if the invested firms do poorly due to recessionary economic settings and thus not meet expected profitability goals or debt obligations. Consequently, financial investors should be sensitive to the performance level of invested firms.

Domestic corporate investors, by contrast, continue to promote such expansive strategies, primarily because they benefit from growing transactional opportunities. Domestic corporate investors are therefore rather less sensitive to performance fluctuations of their invested firms, relative to foreign portfolio and domestic financial investors. In the following sections, we develop hypotheses that test the strategic implications of those differences based on the different investment objectives of these three types of investors.

Restructuring and Ownership Structure

While there are a significant number of studies on the influence of ownership structure on the restructuring of U.S. and U.K. firms (Connelly *et al.*, 2010), research on the Japanese context has been relatively limited. Ahmadjian and Robinson (2001) and Ahmadjian and Robbins (2005) investigate the effect of foreign ownership on the restructuring of Japanese firms and find that firms with larger foreign ownership are more likely to downsize by reducing the number of employees and divesting their assets during the recessionary period of the 1990s. Similarly, a study by Yoshikawa and colleagues (2005) shows that foreign ownership reduces employee wage payments when firm performance is low. That study also illustrates that domestic relational investors tend to protect wage payments even during performance

declines. These findings suggest that foreign portfolio investors and domestic relational shareholders exhibit different preferences over the strategic moves of their invested firms especially during poor the performance of those invested firms.

David and colleagues (2006) examine the interaction effects of foreign ownership and growth opportunities on R&D and capital investments in Japanese firms and reveal that foreign investors promote such strategic investments only when their invested firms have growth opportunities. While their study does not specifically examine firm restructuring, it indicates that strategic preferences of foreign investors vary with the growth opportunities of their invested firms, implying that they discourage certain strategies when such opportunities are not evident. All these studies suggest that strategic preferences of foreign investors are contingent on performance levels or the presence of growth opportunities of their invested firms. Domestic relational investors are less sensitive, by contrast, presumably because direct financial gains from shareholding are a secondary importance of their investment.

The emerging differences between financial institutions and corporate investors should be noted however, even if they have been collectively classified as domestic and relational investors. Both of them had conventionally played a role of “stable” shareholders to shield the invested firms from possible takeover attempts initiated by international as well as domestic institutional shareholders. Yet the unprecedented recession that engulfed the Japanese economy in the 1990s revealed that the behavioral characteristics of these two classes of domestic investors are actually conditional (Fukao 1999; Gedajlovic *et al.*, 2005; Nitta 2000). For analytical purposes as well as policy-oriented discussions, the distinction between the two seems to be a matter of necessity.

Strategic Diversification

Applying a firm’s accumulated resources and capabilities to new businesses can possibly enhance the long-term competitiveness of the firm and thereby increase sales and profits through economies of scale and scope (Datta, Rajagopalan, and Rasheed, 1991; Kim *et al.*, 1993). Through diversification into new product lines that allows a firm to increase the scope of its operations and market

offering, the firm can also reduce its product risks by lowering dependence on narrow products. On the other hand, when a firm diversifies into unrelated areas, it can reduce its dependence on the business cycle of its core products. Hence, diversification can potentially reduce business risks of excessive dependence on limited segments of the market. Finally, diversification strategies also benefit managers by increasing their compensation and status, and by reducing employment risks (Christensen and Montgomery, 1981; Denis *et al.*, 1997).

However, diversification also entails several risks. Extensive diversification may compromise the building and utilization of a sustainable competitive advantage established in its core product areas, because stretching the market portfolio may require a firm to reduce the intensity of its investments in its core businesses and products. Moves into unrelated areas would also make the application of competitive product and market-related knowledge less effective even within a firm (Bettis, 1981; Itami *et al.*, 1982; Porter, 1987; Rumelt, 1974; Wernerfelt, 1984). Further, highly diversified firms are complex and hence costly to manage, which can lead to greater agency costs (Jones and Hill, 1988; Tallman and Li, 1996). Organizational complexity may also lead to management entrenchment because outsiders will find it more difficult to assess internal operations.

Since foreign portfolio investors hold shares to earn immediate financial returns and have a diversified investment portfolio on their own, they would prefer that their invested firms focus on product lines where these firms have core competencies and not attempt to reduce product-related risks at the firm level (Levy and Sarnet, 1970). Especially at the time of economic downturn when the average rate of return becomes lower, market investors demand their invested firms to focus on profit-generating product lines for the sake of overall financial performance. Following these arguments, we suggest that foreign owners will discourage product diversification of their invested firms.

By contrast, domestic stable shareholders that include both corporate investors and financial institutions are composed mainly of capital and loan providers, corporate affiliates, business customers and suppliers, and parent companies. They are stakeholders as well as shareholders whose goals are not simply to gain direct financial returns from their shareholdings. As the corporate partners expand their

product lines, other corporate shareholders may benefit as stakeholders who expect to increase their businesses such as in product and service sales. The financial institutions should then find benefits in business dealings with their clients such as in providing loans and other financial products (Aoki 1988; David *et al.*, 2010; Gedajlovic *et al.*, 2005; Weinstein and Yafeh 1995). Further, product diversification can reduce business risks and thus secure business flow stability between these business partners. Therefore, the more domestic corporate and financial institutional shareholders get into transactions with their invested firms, the more tolerant their attitudes can be toward product diversification.

In addition, Japanese firms, business corporations and financial institutions as well tend to emphasize job security of their employees (Cole, 1979; McMillan, 1996) as discussed earlier, and domestic relational investors share the same norm and practice of long-term employment (Ahmadjian and Robins, 2005). Although they have an incentive to protect the value of their stock investments, they would be more interested in the stable performance of the network of firms in which they are a part of (Yoshikawa *et al.*, 2005). They may sometimes assist financially troubled firms within the network through various means to protect employment by holding the demand for financial returns. As such, they are more likely to accept strategy that protects the job security of employees' of their invested firms. Hence, other things being equal,

H1a: Foreign ownership is negatively associated with the changes in product diversification of their invested firms.

H1b: Domestic corporate ownership is positively associated with the changes in product diversification of their invested firms.

H1c: Domestic financial ownership is positively associated with the changes in product diversification of their invested firms.

While diversification can allow a firm to leverage its proprietary competitive assets in the core product lines in related areas or provide new opportunities to expand its businesses, such strategy still requires a relatively large resource allocation. Even in related product areas, a firm may face different customers, markets, and distribution channels. This means that a firm often has to make additional

investments to enter into a new product line even when it can transfer some strategic resources. When firm performance is low, such additional investments may impose a heavy financial burden. This is especially so when an economic environment is recessionary and market demands are depressed. Under such circumstances, investors who focus on immediate financial returns would not likely support diversification strategy despite its potential financial benefits in the long-run.

After the burst of the bubble economy in the early 1990s and during the subsequent decade-long economic recession of the domestic economy, many Japanese firms suffered from overextended product portfolios that resulted from excessive diversification in the late 1980s (Shimokawa, 2006). Due to the abundant free cash flow from booming businesses and economic opportunities that emerged from rapidly rising domestic demands in the 1980s, many Japanese firms attempted to enter into diverse businesses and product lines that were unrelated as well as related to their product areas. However, since the domestic economic condition in Japan remained recessionary throughout the 1990s, domestic market demands could not meet all the product supply that Japanese firms provided. International markets did not absorb the surplus supply coming out of Japanese firms partially because the Japanese yen stayed strong, which made their products less competitive overseas. Consequently, profitability declined for many of those firms (Colpan and Hikino, 2005; Colpan, 2008).

In such an industry and macroeconomic setting, return-oriented investors are likely to exhibit strong preference for their invested firms to focus their product portfolio on business lines where the firms have competitive advantages. Especially given that any diversification move requires additional investments which affects a firm's financial position, those investors would not likely support such strategy. Based on the argument above, it is expected that foreign portfolio investors will encourage the reduction of product diversification when performance of their invested firms is low.

However, when performance of their invested firms remains high, foreign portfolio investors are likely to be more tolerant of greater product diversification even during a recessionary period. As their invested firms are performing well and foreign portfolio investors are thus gaining financial returns, they have less incentive to demand strategic change of their invested firms. Therefore, when a firm is

performing well, management can choose strategic plans without much interference from foreign investors. Especially during a recessionary period in Japan, managers have an incentive to pursue diversification strategy because it allows them to protect external transactions and employment through growth in new business areas. Higher firm performance should provide management with greater discretion in pursuing diversification even as foreign ownership increases.

While domestic corporate shareholders prefer their invested firms to grow to warrant more business dealings, we expect that they are not that sensitive to the financial performance of their invested firms. Although declining capital and income gains from stockholdings could certainly be significant, as was the case of foreign portfolio investors during performance declines, the strategic and transactional side of their investment would make the domestic shareholders more supportive of increasing product diversification regardless of firm performance. Further, those corporate shareholders are often affiliated firms and business partners, and hence have greater access to corporate information of their invested firms. This smaller information asymmetry between domestic corporate shareholders and their invested firms, compared with that between foreign portfolio investors and their invested firms, would make domestic corporate investors more tolerant of low performances of those firms. This is because easier access to strategic and organizational information makes domestic corporate investors more apprehensive about diversification moves adopted by the management.

As discussed earlier however, the pressures that the two classes of domestic relational shareholders, corporate investors and financial institutions faced were critically different in the 1990s. Financial institutions felt more strain relative to corporate investors due to their mounting bad loans, which resulted in the tightening of government regulations by the newly-established Financial Services Agency that required a reasonable level of financial conditions (Jackson and Miyajima, 2007). Once those financial institutions started encountering troubles in their financial standings, they faced no choice but to incorporate investment principles that instrumentally valued immediate financial gains. Naturally, as long as the performance of invested firms remained reasonably sound, the financial institutions could still hold on to the conventional emphasis on relational ties and support of expansive business plans

toward more diversified product portfolios. However, they are likely to discourage such strategies when the performance of their invested firms remained low because poor performance may lead to financial losses from their stock investments as well as loans. Hence,

H1d: Firm performance positively moderates the relationship between foreign ownership and the changes in product diversification of their invested firms.

H1e: Firm performance does not have significant effects on the relationship between domestic corporate ownership and the changes in product diversification of their invested firms.

H1f: Firm performance positively moderates the relationship between domestic financial ownership and the changes in product diversification of their invested firms.

Capital Commitment

Increased commitment through capital expenditure can enhance a firm's capacity in the short-run and also competitiveness in the long-run. The firm may enjoy greater economies of scale or introduce newer facilities embodying innovative technology making its products more price competitive against its rivals. Price competitiveness through greater scale economies combined with the latest technology may lead a firm to capture larger market shares and higher profits even in a stagnant market. Capital investment into related product categories may enhance competitiveness for a broader sphere of markets through the application of proprietary knowledge nurtured in core domains. When the capital investment is carried out on an international scale, a new location will also bring lower costs and/or larger markets (Nakamura, 1995; Stoneman, 1983). Hence, capital investment may bring some tangible benefits.

Nevertheless, especially in a recessionary macroeconomic environment, large-scale capital investment may also lead a firm to increasing excess capacity and less-than-optimal utilization of new as well as old facilities. Higher capital spending can also impose an additional financial burden on the firm, especially when such spending needs to be financed by external borrowing. If the firm enjoys substantial free cash flow to finance the new investment, portfolio owners may rather want that cash to be paid out to them, especially when market conditions are poor and growth opportunities are limited. Hence, other things being equal, investors who seek immediate financial return may not encourage such large capital

investment. It is thus expected that foreign portfolio shareholders do not support larger capital expenditure.

On the other hand, domestic relational investors, financial institutions as well as business corporations, remain business partners or customers of their invested firms. Despite potential negative effects of extensive capital spending, these shareholders may still encourage or at least not object to such investment because it will increase business flows. Further, as is the case of diversification strategy, greater capital expenditure can stimulate sales growth of the firm and hence promote employment stability in their invested firms. Since domestic relational investors share the norm of employment security and constant business flow, they are more likely to support greater capital expenditure. Hence,

H2a: Foreign ownership is negatively related to the changes in capital commitment of their invested firms.

H2b: Domestic corporate ownership is positively related to the changes in capital commitment of their invested firms.

H2c: Domestic financial ownership is positively related to the changes in capital commitment of their invested firms.

During a recessionary period, the reduction of capital spending may make business sense as market demands are limited. Since existing and potential customers face smaller markets with less profits and cash to spend, a firm with a greater supply capacity would find it more difficult to maintain high capacity utilization rates. Hence, especially when invested firms are experiencing low performance, it is likely that foreign portfolio investors will discourage further capital expenditure. When firm performance is low, the priority of foreign portfolio investors is to reduce excess capacity and thereby improve operational efficiency. When firm performance is high, by contrast, foreign portfolio investors would be more tolerant of capital investment even during a period of economic recession. As long as foreign portfolio investors are gaining reasonable returns from their shareholdings, they are less likely to have a strong incentive to demand extensive strategic reorientation.

By contrast, domestic corporate shareholders still had an incentive to support capital spending by their invested firms even when financial performance of those invested firms remained less than

satisfactory. Since these relational investors often have business ties, larger capital spending may bring more transactions and thereby increase sales volume. As discussed, Japanese managers have an incentive to seek firm growth in part because of their implicit contract with their employees to provide job security. During an economic recession, additional investment may be particularly important for these goals. As firm performance improves, the management will then have greater discretion to make capital investment. Hence, as domestic corporate investors share these behavioral principles, they support greater capital spending. Since they are long-term relational investors, it is expected that their preference over strategies of their invested firms would not vary much by performance fluctuation.

While this relational investment principle held basically true for corporate investors even in the 1990s, the behavioral principle of financial shareholders started incorporating market-oriented characteristics, as mentioned above. Those financial institutions might still value the relational business ties with their clients in the long-run, but were eventually forced by their own financial woes and tightening government regulations to make immediate financial returns the priority over relational concerns. As long as the financial standing of their invested firms remained sound, commercial banks and insurance companies were willing to support large-scale investment plans that should generate more transactional volume as well as profits. When the invested firms were experiencing performance troubles, though, financial institutions became reluctant to encourage such expansive schemes. In the recessionary 1990s, therefore, financial shareholders were sensitive to the financial performance of their invested firms to influence their strategic investments. Hence,

H2d: Firm performance positively moderates the relationship between foreign ownership and the changes in capital commitment of their invested firms.

H2e: Firm performance does not have significant effects on the relationship between domestic corporate ownership and the changes in capital commitment of their invested firms.

H2f: Firm performance positively moderates the relationship between domestic financial ownership and the changes in capital commitment of their invested firms.

DATA AND METHODOLOGY

Sample

The sample covers all the electronics firms that are listed on the First section of Japan's three largest stock exchanges: Tokyo, Osaka and Nagoya. The electronics industry is chosen because it represents one of the most dynamic and successful industries in Japan. Furthermore, electronics firms in the sample include the wide spectrum of cases in terms of their ownership and governance, although all of them were majority-owned by domestic investors. Yet, international shareholders were represented in all of the sample firms. The original sample of 146 firms is reduced to 96 companies in our final analysis after eliminating firms with substantial missing data.³ The time period covers the accounting years from 1992 to 2002, representing the entire duration of the prolonged economic recession. The majority of the statistical data was collected from the *Yuka Shoken Hokokusho (Report on Securities and Stocks)* that is the semiannual reports that listed companies file with the Ministry of Finance; *Nikkei Needs Database*; *Yakuin Shikiho (Directory of Corporate Officers)*; and *Kogyo Tokeihyo (Manufacturing Census)* published annually by the Ministry of Economy, Trade and Industry.

Variables

Dependent variables: This study uses two dependent variables, changes in product diversification and capital commitment. *Product diversification* is a Herfindahl-type measure, which is calculated as

$$1 - \sum_{i=1}^N (S_i)^2 ; \text{ where } S_i \text{ is the share of a firm's total sales in 4-digit JSIC (Japan Standard Industrial}$$

Classification) segment i and N is the number of JSIC industries in which the firm operates. *Capital commitment* represents the ratio of capital expenditure to total assets.

Independent variables: We have three groups of shareholders in our study: foreign ownership, domestic corporate ownership and domestic financial ownership. *Foreign ownership* is the percent of shares held by foreign investors in a firm's total outstanding shares. While foreign ownership categorically includes

both institutional and individual investors, it is safe to assume that most of the shares were held by institutions as global equity investments have largely been carried out by institutional investors in most major countries (Useem, 1998). *Domestic corporate ownership* is composed of non-financial domestic firms that are mainly composed of business partners, either suppliers and/or customers, of invested firms. The impact of these relational shareholders is examined with a variable equal to the percentage of total outstanding shares owned by those corporate owners. *Domestic financial ownership* is the percent of shares held by domestic financial institutions such as commercial banks and insurance companies. The influence exercised by these investors is evaluated by a variable equal to the percentage of total outstanding shares held by Japanese commercial banks and insurance companies. We use return on total sales (ROS) as a firm performance measure, while Robins and Wiersema, 1995 suggest that various measures of profitability are typically correlated. That performance criteria is a common measure of profitability and has often been employed in the Japanese context (Geringer *et al.* 2000; Colpan and Hikino 2005; Yoshikawa and Phan 2001).

Control variables: Several control variables are introduced into the regression models. Those include *firm size*, *firm age*, *leverage*, *liquidity*, *export intensity*, *executive tenure*, *CEO change* and *industry growth*. We control both firm size that is measured by total assets and firm age, because these two factors often influence the pattern and extent of product diversification in particular. Leverage is calculated as the percentage of long-term debt to total employed capital, whereas liquidity is computed as the current assets divided by current liabilities. We measured the exposure to foreign markets by export ratio, calculated as export sales divided by total sales. Executive tenure is the average number of years that current directors served on the board. Longer tenure of the board members often comes with greater board power in a collective sense, which allows them to exercise greater discretion to deal with market pressures and cater to the interests of other stakeholders. A firm's strategic decisions can also be affected by CEO change, which is measured as the number of times the relevant firm installed new CEOs within the period. Average annual growth of industry shipment for 3-digit JSIC sub-industry categories calculated from

Kogyo Tokeihyo (Manufacturing Census) is the industry-level control.

Methodology

Panel data set is employed for the analysis that examines 96 firms for the duration from 1992 to 2002. The estimation technique employed was the General Method of Moments (GMM) model, which allows us to control both for (i) unobservable individual heterogeneity among firms and (ii) endogeneity. To address the first issue, we model the unobserved heterogeneity as an individual effect (α_i) which is thus eliminated by first differencing variables. We also included year fixed effects when required by the model. The second issue could be more severe since endogeneity may arise from any of our main explanatory variables (different types of ownership) and we thus need to measure the reverse causality in the linkage between ownership structure and strategic investments for product diversification and capital commitment. To address the potential endogeneity problem, GMM allows us to use the lagged explanatory variables as instruments. We used system GMM for STATA to run our regressions, since it provides high flexibility and accuracy to identify the proper instruments. We followed Blundell and Bond (1998) and incorporated our lagged explanatory and control variables as instruments for both the equations in differences and the equations in levels. For the interaction models, we also mean-centered the variables of the interaction terms to minimize collinearity.

Finally, since this methodology assumes that there is no autocorrelation in ε_{it} , we calculate m1 and m2 statistics for first and second order autocorrelation in the first difference residuals for all our models. Moreover, the Hansen test of over-identifying restrictions for the dynamic panel data model is also implemented to check the validity of the instruments.

STATISTICAL RESULTS

Table I presents descriptive statistics and correlation coefficients for the variables. As the table shows, there are no significant correlations among the variables. We then check variance inflation factors (VIF) for each variable. As no one value of VIF is larger than 10, which is employed as a rule of thumb to detect

serious multicollinearity, we can say that collinearity does not appear to be a major problem for this study.

-- INSERT TABLE I ABOUT HERE --

Table II illustrates the results of the regression analyses for the product diversification hypotheses. Model 1 shows the coefficients and their significance values for control variables, while Model 2 adds firm performance variable to the first model. Models 3 and 4 present the results for Hypotheses 1a~1c and 1d~1f, respectively. First, we examine the results for direct effects of ownership. Model 3 of the table shows that foreign portfolio ownership is negatively related to the change in product diversification of their invested firms. By contrast, domestic corporate ownership is positively related to the change in product diversification of their invested firms. For domestic financial ownership, however, the results show statistically insignificant signs. These outcomes give support to Hypotheses 1a and 1b; Hypothesis 1c is however not supported. This outcome seems to suggest that financial ownerships are conflicted between two opposing forces: a conventional relational principle and an emerging performance-oriented philosophy. As such, statistically, they do not show any clear direct effects.

Hypothesis 1d proposes that firm performance positively moderates the relationship between foreign ownership and the changes in product diversification of their invested firms. Hypotheses 1e suggests that firm performance does not have significant effects on the relationship between domestic corporate ownership and the changes in product diversification of their invested firms, while Hypothesis 1f predicts positive and significant moderation effects of firm performance on the relationship between the domestic financial ownership and the changes in product diversification of their invested firms. Model 4 rejects Hypothesis 1d as the coefficient is statistically insignificant, which suggests that foreign shareholders ask for lower product diversification of their invested firms regardless of those firms' performance. The model supports Hypothesis 1e and Hypothesis 1f. This implies that domestic financial shareholders have actually become sensitive to the performance of their invested firms, while corporate shareholders have not.

In Table III we present the regression results for the capital investment hypotheses (Hypotheses 2a~2f). Hypothesis 2a predicts that foreign portfolio ownership is negatively related to the change in capital commitment of their invested firms, whereas Hypotheses 2b and 2c propose that domestic corporate ownership and domestic financial ownership are both positively related to the change in capital commitment of their invested firms. Model 3 illustrates that Hypothesis 2a and 2b are supported. Yet Hypothesis 2c is rejected, as the coefficient for financial ownership is insignificant. As was the case with diversification conduct, financial institutions seem to be muddled between their relational behavior of supporting capital commitment by their invested firms and the mounting pressure of immediately improving their own financial performance by rejecting large capital expenditure.

Model 4 in that table supports Hypothesis 2d that predicts that firm performance positively moderates the relationship between foreign ownership and the changes in capital investment of their invested firms. The results provide support for Hypothesis 2e as well, as firm performance does not have any significant moderating effects on the relationship between domestic corporate ownership and the changes in capital investment. The positive and significant coefficients for the interaction term of domestic financial ownership and performance provides support for Hypothesis 2f, which suggests that financial shareholders are sensitive to the performance of their invested firms when those firms make strategic investments.

We also note that two of our control variables are consistently significant for both the product diversification and capital commitment regression analyses. The first of the two relates to the CEO change variable that is positive in the models.⁴ This suggests that when CEOs are replaced more frequently, each of the incoming CEO prefers expansive strategies by committing to more diversified product portfolios and investing in large capital projects. Further, industry growth seems to have a consistently positive impact on those expansion strategies as well, as favorable industry conditions encourage the firms to be growth-oriented.

INSERT TABLES II AND III ABOUT HERE

DISCUSSION AND CONCLUSION

Our results show that foreign shareholders strongly influence their invested firms to narrow down product portfolios to focus on product lines in which they possess competitive capabilities. They also foster conservative capital investment committed by their invested firms. As discussed above, it appears that the objective of foreign portfolio investors remained to be immediate financial gains. They thus represent the new force for change in the Japanese institutional context. By contrast, domestic corporate investors support the strategy of both product diversification and capital investment by their invested firms. This reconfirms the conventional wisdom that those relational investors can benefit from the growth of their invested firms through increased transactions and business flows. Further, the outcome supports the view that domestic relational investors encourage such strategies that may provide employment security in their invested firms. These results are also consistent with our argument that domestic relational investors play a role to maintain continuity of the local institutional arrangements.

Our results, however, indicate that the attitudes of domestic financial institutions are now ambiguous about both diversification moves and capital expenditure. They did not support those strategies but did not actively oppose them either. This is probably because they were under strong pressure to improve their own financial performance in the recessionary economic environment of the 1990s, yet also had to maintain their conventional business ties to the invested firms. Thus, it appears that they were struggling between this immediate interest in financial gains and the long-standing relational ties to their clients and affiliated corporations.

Our findings on the interaction terms of foreign ownership and firm performance show their characteristic preferences in terms of the strategic orientations of their invested firms. We found that firm performance did not have any significant effects on the relationship between foreign ownership and diversification strategy but had positively moderated the relationship between foreign ownership and capital commitment. These outcomes suggest, first, that foreign portfolio investors prefer a focused

product portfolio regardless of the financial performance of their invested firms. Those investors appear to believe firmly in the financial merits of focused product portfolios. Our results, however, imply that they tolerate expansive capital investment moves as long as firm performance is high, while they discourage those investments when firm performance is low. By contrast, the interaction terms of domestic corporate ownership and firm performance had no relation with either of the two strategic measures. This behavior is consistent with the domestic corporate shareholders' basic goals in the maximization of business volumes and transactions regardless of the financial returns from their share ownership.

Our results on domestic financial shareholders are worth for some elaboration: Financial institutions had become notably sensitive to the performance fluctuations of their invested firms. Our findings show that as long as firm performance is high, the domestic financial investors support both greater diversification and more capital investment. However, they oppose both of those strategic moves when their invested firms face performance difficulties (Hoshi, Kashyap and Scharfstein, 1990).⁵ This preference differs from that of foreign investors or domestic corporate shareholders. Our results thus partially support previous studies in that the interests and motivations of foreign portfolio investors and domestic relational owners are clearly different (e.g., Ahmadjian and Robbins, 2005; David *et al.*, 2010; Yoshikawa *et al.*, 2005). However, the present study shows that the conventional domestic shareholders that had been uniformly regarded as relational investors are now actually two distinctive groups: while corporate investors still remain relational, financial shareholders have slowly shifted their investment principle and moved toward being more market-oriented. It appears that Japanese firms are now under pressure from domestic financial institutions as well as foreign portfolio investors to be more sensitive to their performance when they make strategic choices.

Our findings suggest that with the globalization of capital markets, the Japanese institutional context is facing the delicate balance of change and continuity. The rise of return-oriented domestic financial institutions as well as foreign portfolio investors seems to have some impact on the strategic behavior of Japanese firms. At the same time, domestic corporate owners still appear to be relational in their institutional norms even during the recessionary period of the 1990s. They represent continuity in

the Japanese institutional framework. The different orientations that the three groups of shareholders exhibit are consistent with the institutional theory argument that institutional change is usually incremental, and in that process continuity and change often co-exist (Leblebici *et al.*, 1991; Townley, 2002).

Research on Ownership Issues for Japanese Firms

Our study contributes to the literature on the strategic impact of ownership heterogeneity. Previous studies suggested that different ownership categories have varying effects on firm strategies, and CEO compensation in the U.S. and European contexts (David, Kochhar and Levitas, 1998; Hoskisson *et al.*, 2002; Thomsen and Pedersen, 2000; Connelly *et al.*, 2010). Past research that examined the ownership structure in the Japanese context found that foreign owners and domestic owners have different investment objectives, which influence strategic behaviors of their invested firms. Those studies look at downsizing (Ahmadjian and Robinson, 2001; Ahmadjian and Robbins, 2005), reduction of employee wages (Yoshikawa *et al.*, 2005), R&D and capital investment (David *et al.*, 2006), and corporate performance (Gedajlovic *et al.*, 2005; Miyajima, 2007; Miyajima and Kuroki, 2007; Yoshikawa and Rasheed, 2010). A recent study by David and colleagues (2010), which investigates the performance implications of diversification strategy under different ownership composition, suggests that foreign owners appropriate the rents from corporate diversification through higher profits, while domestic owners gain the rents from corporate diversification through higher growth. Previous research hence indicates that foreign and domestic ownership is an important distinction in the Japanese context.

Building on and extending these studies, we have focused on the effects of ownership structure on two aspects of long-term strategic investments, product diversification (an original and fine-grained four-digit JSIC measure calculated from the individual company security reports filed with the Ministry of Finance) and capital investment during the recession period in Japan. We extend previous research in particular in examining the strategic implications of owners' sensitivity to firm performance, i.e., how *firm performance* influences the investment preferences of different types of shareholders. We technically

do this by investigating how firm performance moderates the relationship between the different types of owners and changes in strategic investments of their invested firms. This inclusion of interactive effects gives the current study a different perspective that reveals a more detailed pattern that heterogeneous owners exhibit, i.e., what different shareholders would demand in terms of corporate investment under performance declines. We reason that as long as foreign and domestic financial owners are concerned with the financial standing of their invested firms, their strategic preferences should be sensitive to the financial performance of those firms. On the other hand, we argue that domestic corporate owners should be less sensitive to financial performance due to their strategic interests, and hence continue to support strategies that enhance firm growth regardless of the invested firms' financial performance.

Further, unlike the previous studies, we argue that even among domestic owners, financial institutions and non-financial firms have different interests especially during the period of our study. While most previous studies including the most recent one by David *et al.*, 2010 have treated domestic institutional owners as a single group with an objective of growth and relational orientation, the present study divides them into two distinctive categories. Not only foreign and domestic shareholders are separated, but domestic owners are further divided into the categories of financial institutions and that of non-financial corporations. This dichotomy is based on the hypotheses that the investment behavior of those three groups of shareholders (foreign, financial and corporate) should differ. As it turns out, we found that the two groups of domestic shareholders are actually dissimilar in terms of their influence on product diversification and capital commitments, presumably because their investment objectives are different. Only corporate shareholders behave in the way that past research has theorized. Domestic financial owners exhibit interesting characteristics that are somewhere between foreign portfolio owners and domestic relational shareholders. This point about the heterogeneity of domestic shareholders is one of the originalities of the current study.

This study provides evidence that Japanese firms are increasingly pressured to deal with the conflicting investment objectives of domestic corporate, domestic financial as well as foreign investors. Any one of the three does not share identical institutional norms with another. We demonstrated that

foreign portfolio investors, who act based on the norms of global capital markets, pressed for a narrow product portfolio that is symbolized in the “focus on core competencies” philosophy. They also actively seek their invested firms to cut back capital investment, which is particularly true when the performance of those firms remains poor. This means that as foreign ownership grows further, Japanese firms need to be more responsive to their own performance whenever they make strategic decisions. On the other hand, domestic corporate owners, who are less sensitive to the financial performance of their invested firms, appear to play a prime role in maintaining the local institutional norms. Interestingly, however, domestic financial investors such as commercial banks and insurance companies are now sensitive to the performance of their invested firms. Once the pillar of Japan’s relational investing, their gradual shift toward market-orientation certainly affects the preference of strategic choices on the part of the invested firms.

Future Research Directions and Limitations

Our findings point to further research. While our results suggest that firms with larger foreign ownership and domestic financial shareholders were more likely to adjust their diversification strategy and capital investment depending upon their performance levels, what we still do not know is whether those firms would return to pursue growth-oriented strategies regardless of their performance once foreign ownership declines and business environments improve to press domestic financial institutions to reconsider their investment preferences. If their performance priorities shift simply because of their shareholding compositions, then institutional change does not exhibit a linear trajectory; it can reverse when the environment swings. However, ownership structure is only one component in the environment. When other components such as corporate law and accounting rules also move toward more market-oriented models from the relationship-based practices (Peng, 2003), then it is expected that firms will continue to pursue the interests of market investors even when ownership by such investors as foreign portfolio investors declines and domestic financial shareholders readjust their investment principles. For example, the changes in the Japanese accounting rules since the late 1990s, which were caused by the globalization of accounting

standards and capital markets, led many Japanese firms to reduce their shareholdings in other affiliated and customer firms to mitigate the effects of stock market fluctuations on their performance (Okabe, 2002). Also, a large increase in both cross-border and domestic merger and acquisition activities has made Japanese managers pay closer attention to stock prices of their firms, because lower market value may make their firms an attractive target of takeovers (*Nihon Keizai Shimbun*, February 15, 2007). Further, the recent revision in corporate law, which allows Japanese and foreign firms to acquire other Japanese firms using their own equity (the common practice in the U.S. market) has made Japanese managers more aware that higher stock prices are their instrumental defense against takeover attempts as well as a strategic tool to acquire other firms (*Nihon Keizai Shimbun*, October 9, 11, 2004). Since the strategic and performance implications of these changes in the institutional context are still far from being clear, there are many opportunities to be explored.

One of the limitations of this study is that we chose our sample only from the electronics industry. We selected this industry because it is under greater pressure to change due to its exposure to foreign investors from the early years. While this may be the appropriate industry to detect any change, a single industry study naturally limits generalizability of the findings. Future research should expand the industry scope and examine the industry-level differences as well as the generalizability of our findings. Another line of future possible research is to incorporate the latest change of ownership composition. Recent research suggests that domestic pension funds and investment trusts (mutual funds) have started to gain increasing presence in the Japanese stock markets, although they were still relatively small and largely passive during the time period of this study (Fukao, 1999; Suto and Toshino, 2005). Comparable to foreign portfolio investors but different from domestic investors such as commercial banks and insurance companies, these market investors seek immediate financial returns and some of them are quite vocal in demanding higher performance and improvements in corporate governance of their invested firms (Yano, 2004). Hence, this group of domestic shareholders may begin to exert additional pressures to shift the priorities of Japanese firms and may become the agent of change.

Further, our findings indicate that there is a tension or conflict between the different types of investors who do not share the same institutional norms within Japanese firms. It is possible that we will

find similar conflicts among global institutional investors and different local shareholders such as family, domestic firms, and government entities. More research on the effects of domestic and foreign or market ownership, and their impacts on institutional change and on strategic and corporate governance changes in other institutional/country contexts are needed to better understand the relationships between changing institutional pressures, increasing ownership heterogeneity and their strategic implications.

To conclude, this study contributes to research on the strategic impact of ownership heterogeneity by examining the characteristic investment preferences of different types of shareholders in the Japanese context. The present research particularly extends earlier work by identifying how firm performance influences the investment preferences of different types of shareholders. It therefore pins down the strategic investment implications resulting from different owners' sensitivity to firm performance. Further, it makes an important contribution as it clearly distinguishes the dissimilar behavioral characteristics of the two groups of domestic shareholders in Japan, corporate and financial, that have been customarily treated as one coherent entity. Ultimately, then, the three types of shareholders, foreign as well as domestic financial and domestic corporate, hold characteristic preferences in terms of the strategic investment committed by their invested firms. This study thus implies that Japanese firms are now under increasing pressure to deal with the conflicting investment directions that the three different types of investors prefer.

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Table I. Descriptive Statistics and Pearson Correlation Coefficients

	Mean	Standard deviation	ROS	Foreign Ownership	Financial Ownership	Corporate Ownership	Firm Age	Firm Size	Leverage	Liquidity	Export Intensity	Executive Tenure	CEO Change	Industry growth
ROS	5.227	8.004	1.000											
Foreign Ownership	9.285	9.621	0.396	1.000										
Financial Ownership	36.750	14.056	0.024	0.239	1.000									
Corporate Ownership	22.345	17.274	-0.139	-0.359	-0.460	1.000								
Firm Age	51.365	16.439	-0.314	-0.040	0.278	-0.054	1.000							
Firm Size	6.E+08	1.640E+09	-0.088	0.308	0.191	-0.194	0.347	1.000						
Leverage	0.434	0.876	-0.179	-0.099	-0.021	0.062	0.095	0.064	1.000					
Liquidity	0.589	0.291	-0.484	-0.278	-0.103	0.289	0.401	0.162	0.290	1.000				
Export Intensity	22.480	17.927	0.121	0.161	-0.105	-0.102	-0.377	-0.068	0.028	-0.108	1.000			
Executive Tenure	6.897	2.723	0.319	0.200	0.200	-0.494	-0.336	-0.139	-0.155	-0.444	0.259	1.000		
CEO Change	1.707	0.886	-0.236	-0.005	-0.169	0.082	0.307	0.056	0.071	0.272	-0.009	-0.246	1.000	
Industry Growth	2.596	13.151	0.227	0.059	-0.118	0.038	-0.144	-0.055	-0.002	-0.075	-0.007	0.035	-0.039	1.000

N=1056

Table II. GMM Regression Results on Δ Product Diversification

	Model 1		Model 2		Model 3		Model 4	
Firm age	5.76E-04***	0.000	5.06E-04***	0.000	3.99E-04***	0.000	9.30E-04***	0.000
Firm size	-8.47E-13*	0.092	-2.75E-13	0.668	-2.68E-14	0.914	8.10E-13	0.668
Leverage	-0.011***	0.000	-0.010***	0.000	-0.005***	0.000	-0.012***	0.000
Liquidity	-0.023***	0.000	-0.024***	0.000	-0.002**	0.031	-0.053***	0.000
Export intensity	0.001***	0.000	0.001***	0.000	0.000***	0.000	0.001***	0.000
Executive tenure	-0.001***	0.000	-0.001***	0.002	0.001***	0.000	0.001**	0.002
CEO change	0.007***	0.000	0.007***	0.000	0.001*	0.081	0.013***	0.000
Industry growth	3.08E-05**	0.002	7.19E-05***	0.000	1.39E-04***	0.000	2.37E-04***	0.000
ROS			3.43E-04***	0.000	-0.001***	0.000	-0.003***	0.000
Foreign Ownership					-1.51E-04***	0.000	-3.50E-04***	0.000
Financial Ownership					-6.82E-05	0.295	0.001***	0.000
Corporate Ownership					4.27E-04**	0.021	0.001***	0.000
FO*ROS							-1.32E-04	0.509
FI*ROS							8.06E-05***	0.000
CO*ROS							-5.13E-06	0.645
Constant	-0.059***	0.000	-0.057***	0.000	-0.038***	0.000	-1.79***	0.000
m ₁	-3.48	(0.001)	-3.50	(0.000)	-4.31	(0.000)	-3.45	(0.001)
m ₂	-0.95	(0.342)	-0.96	(0.336)	-0.75	(0.453)	-0.80	(0.425)
Wald	2765.12	(0.000)	799.52	(0.000)	2317.2	(0.000)	23712.53	(0.000)
Hansen	76.49	(1.000)	74.12	(1.000)	65.51	(1.000)	71.18	(1.000)

(i) Coefficients and p-values are shown in the table for each model

(ii) ***, **, * indicate significance at the 1%, 5% and 10% level, respectively

(iii) Panel data models are estimated by using system GMM for dynamic panel data for Stata.

(iv) Models are estimated after taking first differences of the variables so as to eliminate the individual effect; lags for the dependent and the explanatory variables have been used as instruments in order to control for endogeneity.

(v) m_1 and m_2 are the tests of serial correlation of order 1 and 2, respectively, using residuals in first differences. They are asymptotically distributed as $N(0,1)$ under the null of no serial correlation. The former is expected to be negative and significant and the latter is expected to be insignificant.

(vi) Wald is a test of the joint significance of the coefficients; it is asymptotically distributed as χ^2 under the null of no serial correlation. P-values are shown in parentheses.

(vii) Hansen is a test of the over-identifying restrictions, asymptotically distributed as χ^2 under the null of no correlation between instruments and error terms. P-values are shown in parentheses.

(viii) $N=1056$

Table III. GMM Regression Results on Δ Capital Commitment

	Model 1		Model 2		Model 3		Model 4	
Firm age	-0.089	0.112	-0.019	0.895	0.018	0.155	0.013	0.186
Firm size	1.32E-10	0.621	-1.09E-10	0.872	5.32E-10***	0.001	-1.50E-11	0.840
Leverage	-0.125	0.894	-6.769**	0.017	-0.485*	0.060	-0.020	0.766
Liquidity	8.852***	0.000	14.362***	0.000	0.804	0.243	0.368	0.241
Export intensity	-0.064**	0.014	-0.040	0.509	-0.013	0.207	-0.015	0.143
Executive tenure	1.088***	0.000	1.390***	0.009	0.520***	0.000	0.244***	0.000
CEO change	1.239*	0.058	-0.510	0.727	1.388***	0.000	1.141***	0.000
Industry growth	0.111**	0.007	0.184***	0.002	0.031***	0.000	0.060***	0.000
ROS			0.177	0.250	0.095***	0.000	-1.180***	0.000
Foreign Ownership					-0.116***	0.001	-0.034***	0.001
Financial Ownership					-0.011	0.510	0.016	0.101
Corporate Ownership					0.018**	0.050	0.020**	0.025
FO*ROS							.044***	0.000
FI*ROS							.0129***	0.000
CO*ROS							-0.002	0.151
Constant			4.292	0.665	-3.492**	0.030	-5.290***	0.000
m_1	-3.93	0.00	-3.55	0.00	-3.76	0.00	-3.81	0.00
m_2	-0.70	-0.48	-1.28	-0.42	-0.09	-0.93	1.65	-0.10
Wald	8.79	0.00	44.67	0.00	27.28	0.00	3485.50	0.00
Hansen	27.1	-0.21	26.30	-0.45	55.58	-0.56	77.39	-0.88

(i) Coefficients and p-values are shown in the table for each model

(ii) ***, **, * indicate significance at the 1%, 5% and 10% level, respectively

(iii) Panel data models are estimated by using system GMM for dynamic panel data for Stata.

(iv) Models are estimated after taking first differences of the variables so as to eliminate the individual effect; lags for the dependent and the explanatory variables have been used as instruments in order to control for endogeneity.

(v) m_1 and m_2 are the tests of serial correlation of order 1 and 2, respectively, using residuals in first differences. They are asymptotically distributed as $N(0,1)$ under the null of no serial correlation. The former is expected to be negative and significant and the latter is expected to be insignificant.

(vi) Wald is a test of the joint significance of the coefficients; it is asymptotically distributed as χ^2 under the null of no serial correlation. P-values are shown in parentheses.

(vii) Hansen is a test of the over-identifying restrictions, asymptotically distributed as χ^2 under the null of no correlation between instruments and error terms. P-values are shown in parentheses.

(viii) $N=1056$

Notes:

¹ Gedajlovic et al. (2005) consider six descriptive groupings of shareholders; however they do not coherently systematize the behavioral characteristics of different types of domestic investors.

² One of the authors interviewed a number of executives and senior managers of business firms and officials of the stock exchange between 2002 and 2005 as a part of large research project on corporate governance in Japanese firms.

³ As we checked, the removal of those companies did not bring about the sample bias in terms of the variables used in the study.

⁴ We thank one of the anonymous reviewers in suggesting the inclusion of this control variable.

⁵ Hoshi, Kashyap and Scharfstein (1990) argued that Japanese main banks as the relational providers of long-term as well as short-term loans rescued their financially distressed clients through restructuring. Our results here, on the other hand, suggest that financial institutions in general are sensitive to any performance fluctuations of their invested firms because those financial institutions now own corporate shares as a financial portfolio as well as a relational instrument.